STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NEW ENGLAND GAS COMPANY'S	:	
DISTRIBUTION ADJUSTMENT CLAUSE	:	DOCKET NO. 3548

REPORT AND ORDER

I. NEGAS' JULY 30, 2004 FILING

On July 30, 2004 the New England Gas Company ("NEGas"), a division of Southern Union, filed updated factors to the Distribution Adjustment Clause ("DAC") for effect November 1, 2004. NEGas' proposed DAC would increase the bill for the average residential heating customer of NEGas by $29 per year.

In support of its filing, NEGas submitted pre-filed testimony by Peter Czekanski, Director of Pricing for NEGas. Mr. Czekanski explained that the DAC includes an annual system pressure factor related to liquefied natural gas ("LNG"), a Demand Side Management ("DSM") factor, a Low Income Assistance Program ("LIAP") factor, an Environmental Response Cost ("ERC") factor, an On-System Margin Credit factor, a Weather Normalization factor, an Earning Sharing factor, and a Reconciliation factor for the previous year.[1]

As for the system pressure factor, NEGas proposed an increase in the factor to $0.0054 per therm. The factor is based on the commodity related portion of LNG costs projected from November 2004 through October 2005. In regards to DSM, Mr. Czekanski explained that the DSM program was established in Docket No. 2025 to promote the development of energy-efficient natural gas technologies that increase utilization of natural gas during periods of low demand. He noted that increased off-peak usage reduces the unit cost of gas for all customers by generating distribution revenues to

[1] NEGas Ex 1: (Czekanski's direct testimony), pp. 2-4.

support fixed costs associated with resources needed during peak periods. He explained that NEGas is a participant in the Rhode Island Greenhouse Gas initiative. NEGas proposed no change to the existing level of funding, which is $300,000 annually. He noted that NEGas has $1,307,000 available, which reflects a carry-over of $1,007,000 from fiscal year 2004. For LIAP, Mr. Czekanski stated that this factor provides additional funding to LIHEAP and to a low income weatherization program. He noted that annual funding in distribution rates for LIHEAP and weatherization are $1,585,000 and $200,000, respectively. NEGas proposed no change to the current level.

In relation to the ERC factor, NEGas proposed an increase in the factor to ($0.0018) per therm. This factor reflects a 10 year amortization of environmental response costs. The net environmental costs for fiscal year 2004 were $187,282. In the area of non-firm margins, NEGas proposed a credit of ($0.0007) per therm. Mr. Czekanski calculated that NEGas recorded $1,928,686 of non-firm margins or $328,686 more than the $1.6 million threshold, which results in 75%, or $246,514, to be credited to customers and 25%, or $82,171, to be retained by shareholders. As to weather normalization, NEGas proposed a factor of ($0.0015) per therm. Mr. Czekanski noted that during the winter period of November 2003 through April 2004, the weather was slightly colder than normal and there were 58 degree days in excess of the threshold. As a result, $522,000 was to be credited to customers.[2]

Mr. Czekanski explained that the earning sharing calculation had not been completed because NEGas' financial data for the fiscal year ending June 30, 2004 had not been completed, but NEGas will supplement this filing and provide the calculation no later than September 1, 2004. This filing will include the adjustments made at the April

[2] Id. pp. 4-10.

2004 open meeting by the Commission to NEGas' earning sharing calculation for fiscal year 2003. Also, Mr. Czekanski stated that NEGas incurred no service quality penalties for fiscal year 2004. As for the reconciliation factor for fiscal year 2003, NEGas proposed a factor of $0.0015 per therm. The total undercollection was $538,656, which was primarily due to LNG commodity costs being higher than projected.[3]

II. NEGAS' SEPTEMBER 3, 2004 FILING

On September 3, 2004, NEGas submitted the direct testimony of Robert Riccitelli, Manager of Financial Reporting and Budgeting for NEGas, and the supplemental testimony of Peter Czekanski. Mr. Riccitelli provided the calculation of NEGas' earnings under the earning sharing mechanism ("ESM"). He determined that for the fiscal year ending June 30, 2004, the return on equity ("ROE") was 11.64 percent, and therefore ratepayers were entitled to a credit of $314,125 or ($0.0011) per therm for the period November 1, 2003 through October 31, 2004. NEGas determined that its net income available for common equity for the fiscal year ending June 30, 2003 was $12,239,240. This was based on various adjustments to NEGas' operating revenues and expenses. First, fiscal year 2003 had a colder than normal winter resulting in $522,000 to be returned to ratepayers through the Weather Normalization Clause. As a result, the operating income for purposes of the ESM is reduced by $522,000. Second, NEGas' portion of non-firm margins are excluded from fiscal year 2003, or $82,171 from the ESM. Third, NEGas and the Division agreed to remove stored gas inventory from rate base and to eliminate carrying costs on stored gas inventory from revenues, which decreases operating revenues by $2,269,055. Fourth, NEGas excluded unbilled revenues from the ESM, increasing operating revenues by $1,161,337 and then increasing

[3] Id. pp. 10-16.

operating expenses by $809,416 to reflect unbilled gas costs. Fifth, NEGas excluded the effect of FY 2003 ESM over-earnings and an estimate of FY 2004 ESM over-earnings for a total of $1,914,647. Sixth, NEGas included the investors' share of annual net merger savings, or $2,049,000 in operating expenses. Seventh, NEGas excluded 50 percent of NEGas' incentive compensation, which decreased operating expenses by $686,644 and excluded all expenses related to corporate level incentive compensation. Eighth, NEGas excluded all lobbying expenses from the ESM. Ninth, NEGas excluded 50 percent of advertising and public relations, which decreased operating expenses $39,637. Lastly, for other interest expense, NEGas included only those costs associated with customer deposits and the conservation loan program.[4]

Also, in light of the discussion in the previous ESM proceeding regarding the calculation of accumulated deferred income taxes ("ADIT"), NEGas worked to separate deferred income taxes related to accelerated depreciation and excluded amounts booked pursuant to FAS 109 for the Rhode Island portion of NEGas. Thus, NEGas rolled forward the ADIT balance related to depreciation less FAS 109 from the time of the merger through June 30, 2004. The roll-forward calculation includes the estimated ADIT at year-end and the true-up amount for the previous year. In addition, for the ESM NEGas utilized the statutory tax rate of 35 percent for calculating NEGas' federal income taxes. Mr. Riccitelli utilized an imputed capital structure of: 43.6 percent common equity, 1.9 percent preferred stock, 45.7 percent long-term debt, and 8.8 percent short-term debt. He also utilized the following cost of capital rates: 11.25 percent for common equity, 9.93 percent for preferred stock, 7.81 percent for long-term debt, and 2.02 percent for short-term debt, which is based on the recent 12 month average cost of short-term

[4] NEGas Ex. 4 (Riccitelli's direct testimony), pp. 2-6.

debt for Southern Union. Also, NEGas included funds associated with the allowance for funds used during construction in calculating operating income.[5]

In calculating the rate base, NEGas used a five-quarter average ending June 30, 2004. However, Mr. Riccitelli excluded environmental response costs and prepaid taxes from the rate base. He did include construction work in progress in the rate base and computed the working capital allowance pursuant to the method approved in Docket No. 2286. Also, the deferred debits in the rate base included Y2K costs, amortized at the rate of $240,000 per year, and excluded the costs associated with the Legacy customer-information systems. He noted that earnings between 11.25 percent ROE and 12.25 percent ROE are shared equally between shareholders and ratepayers while earnings above 12.25 percent are shared by giving 75 percent to ratepayers and 25 percent to shareholders. As a result, Mr. Riccitelli calculated $314,125 to be returned to ratepayers.[6] Mr. Riccitelli acknowledged a substantial increase for FY 2004 in bad debt write-offs, net of recoveries, totaling $11,530,015 and an uncollectible expense amounting to $9,149,630. He attributed the higher level of charge-offs to the winter of 2003-2004 having high gas bills due to cold weather and high gas prices. Furthermore, he stated many customers with large arrearages do not return as the customer of record, thus causing those relatively large arrearage amounts to go uncollected. As for the ESM calculation for fiscal year 2003, Mr. Riccitelli calculated an additional $76,420 in earning sharing as a result of Order No. 17971 based on various small adjustments and the exclusion of interest expense on the conservation loan program.

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[5] Id. pp. 5-6.
[6] Id. pp. 6-13.

Mr. Czekanski updated the proposed DAC. He updated the LNG commodity costs from $1,908,365 to $2,004,744 or $0.0056 per therm for the System Pressure Factor. Mr. Czekanski also included the calculation for the ESM of $314,125 and the additional $76,420 for fiscal year 2003. Accordingly, there is a proposed DAC charge of $0.0021 per therm.[7] The impact of the proposed DAC on a typical customer bill is an increase of two percent or $28 per year.[8]

III. DIVISION'S DIRECT TESTIMONY

On October 8, 2004, the Division of Public Utilities and Carriers ("Division") submitted the direct testimony of Bruce Oliver. Mr. Oliver discussed all elements of the DAC except the ESM. For the system pressure factor, Mr. Oliver determined that NEGas' proposed factor filed on September 3, 2004 was mathematically accurate. However, Mr. Oliver indicated that because of NEGas' increased use of LNG for dispatch, the Commission should require NEGas to track its LNG use over the next winter and assess in its next DAC filing whether 20.39 percent of LNG costs should continue to be associated with maintenance of system pressures or whether a higher percentage of LNG should be recovered by the GCR. For the DSM factor, Mr. Oliver noted that $737,503 remains unexpended. Accordingly, Mr. Oliver found the current DSM funding was more than adequate but stated that if anticipated expenditures do not arise, the Commission may wish to cap the amount of DSM funding that is carried over and provide a credit to customers. For the LIAP factor, Mr. Oliver stated that the LIAP funding is $1,793,901 per year. In fiscal year 2003, $1,615,310 was disbursed for Low Income heating assistance and $200,000 was disbursed for Low Income Weatherization.

[7] This figure was later revised to $0.0019 per therm.
[8] NEGas Ex. 2 (Czekanski's supplemental testimony) pp. 1-3.

Mr. Oliver found no reason to question NEGas' level of LIAP funding except that NEGas should include any carry forward balance in future LIAP calculations.

Regarding the ERC factor, Mr. Oliver noted that NEGas is seeking approval of a net recovery of ($641,514). This negative amount reflects: a 10-year amortization of $12,510,252 of ERC costs incurred through the end of fiscal 2002; a 10-year amortization of ($6,012,673) of ERC costs for fiscal 2003; a 10-year amortization of ($187,282) of ERC costs for fiscal 2004; and a deduction of $1,310,000 for budgeted base rate recovery of ERC costs. He disagreed with NEGas' proposed ERC factor because it improperly included $660,242, which was a cost for a "general enviro issues" that was neither a newly incurred environmental cost nor a cost for which NEGas requires further compensation. Thus, he increased the ERC credit from $0.0018 per therm to $0.0020 per therm. However, Mr. Oliver stated that NEGas had not provided sufficient information to support a determination regarding the reasonableness and prudence of the insurance settlements that NEGas has credited against the costs it has incurred.[9] Also, Mr. Oliver stated NEGas should be required to demonstrate that $263,263 in Mercury related environmental expenditures from the former Valley Gas, transferred to NEGas, were not already recovered through Valley Gas rates. Furthermore, to facilitate reviewing NEGas' ERC, the Division recommended that NEGas be required to file a mid-year environmental report indicating the environmental costs and credits incurred and anticipated. Also, the Division recommended that NEGas submit in its annual DAC filing identical information for the second half of the fiscal year along with any revision to the prior first half of the fiscal year as well as the forecast for the upcoming first half of the fiscal year.

[9] Div. Ex. 1 (Oliver's direct testimony), pp. 3-20.

In the area of on-system margin credits, Mr. Oliver accepted NEGas' calculation. As for the weather normalization factor, Mr. Oliver found NEGas' proposed factor to be accurate. However, Mr. Oliver suggested that there may be a need to revise this methodology in the future to better reflect the increasing need of peak supply so as to have revenue adjustments more closely track the actual impacts of weather on customers' usage and NEGas' billings. Also, Mr. Oliver found NEGas' proposed DAC reconciliation factor to be appropriate.[10]

IV. DIVISION'S SUPPLEMENTAL TESTIMONY

On October 22, 2004, the Division submitted the pre-filed direct testimony of David Effron. Mr. Effron discussed the ESM calculation. Mr. Effron increased the operating income by $162,000 to reflect a gain in the disposition of property. Also, he stated that the interest on the conservation loan program should not be deducted from operating income because the conservation loan program represents interest accrued on a credit balance of non-investor supplied funds. Thus, Mr. Effron calculated net income available for common equity of $12,378,000.[11]

For rate base, Mr. Effron reduced the rate base by $133,000 because the prepayment of the PUC assessment is actually paid in the third quarter of the fiscal year but NEGas begins accruing for the expense at the beginning of the fiscal year. For ADIT, Mr. Effron pointed out that NEGas was incorrect in its calculation because NEGas does not adjust the balance of ADIT existing at the beginning of the fiscal year until the end of the fiscal year. As a result, Mr. Effron modified the ADIT to increase the average balance by $1,019,000. Also, Mr. Effron modified the cash working capital balance by

[10] Id. pp. 12-18.
[11] Div. Ex. 2 (Effron's direct testimony), pp. 1-7.

indicating that the amount of cash working capital balance for the twelve months ended June 30, 2004 is the amount that should be included in rate base. Furthermore, Mr. Effron reduced the rate base by $885,000, which was the balance of Contributions in Aid of Construction ("CIAC") on June 20, 2004, because until the funds are expended, the contributions represent non-investor funds since they are cash advances from developers for facilities to be constructed by NEGas. As a result, Mr. Effron calculated a rate base of $240,419,000 and determined that NEGas' return on equity was 11.81% for fiscal year 2004 for an earning sharing credit of $450,000. Lastly, Mr. Effron calculated the incremental earning sharing for fiscal year 2003 to be increased from $76,000 to $99,000 to eliminate the $31,000 for conservation loan program as an expense.

V. NEGAS' REBUTTAL TESTIMONY

On November 1, 2004, NEGas submitted the pre-filed rebuttal testimony of Robert Riccitelli. Mr. Riccitelli agreed to Mr. Effron's adjustment of $162,000 on the disposition of property to be included in net income. Also, Mr. Riccitelli agreed to Mr. Effron's adjustments related to interest from the conservation loan program that is funded from non-investor supplied funds.[12]

NEGas disagreed with the other recommendations of the Division. For the prepayment of the PUC assessment, Mr. Riccitelli disagreed with Mr. Effron's recommendation that it should be calculated as a negative $82,000 for fiscal year 2004. Mr. Riccitelli explained that NEGas accrues the annual PUC assessment on a monthly basis and once the invoice is received and paid, NEGas adjusts the accrued expense to deduct the actual payment. Also, Ms. Riccitelli noted that under GAAP there is no basis to establish a negative prepayment and that prepayments can only be positive or zero.

[12] NEGas Ex. 5 (Riccitelli's rebuttal testimony), pp. 1-4.

For the ADIT, Mr. Riccitelli stated that Mr. Effron's approach represents a change in accounting practices for the ESM calculation and that it would remove amounts booked by NEGas in the fourth quarter. As for Mr. Effron's calculation of the cash working capital, Mr. Riccitelli indicated that this approach was flawed because it would be inconsistent with prior ESM calculations as well. For CIAC, Mr. Riccitelli stated that the CIAC figure is based on billings rather than the actual amount paid by customers, and that Mr. Effron based his CIAC adjustment on the June 30, 2004 amount rather than a five quarter average.[13]

Lastly, Mr. Riccitelli stated that through the process of discovery in the non-ESM portion of the DAC proceeding, NEGas discovered that it had erroneously included $660,242 as a charge to environmental remediation cost. Thus, NEGas adjusted both environmental amortization expense and deferred gas costs which are income statement accounts, which resulted in deferred gas costs being understated by $573,422. Mr. Riccitelli noted that he included $573,422 of this expense in the ESM calculation. All of Mr. Riccitelli's adjustments result in a lowered ESM credit for fiscal year 2004 of $108,569.[14]

VI. DIVISION'S SURREBUTTAL TESTIMONY

On November 8, 2004, the Division submitted the pre-filed surrebuttal testimony of David Effron. For the prepayment of the PUC assessment, Mr. Effron stated that since the payment occurred after the mid-point of the year, it should be considered paid in arrears and not in advance. As for the ADIT, Mr. Effron noted that the Commission has not adopted a particular method for calculating NEGas' ADIT for the ESM and that the

[13] Id., pp. 4-13.
[14] Id., p. 14.

source of funds provided by deferred taxes are realized over the course of the year and not suddenly at the end of the year. Regarding cash working capital, Mr. Effron indicated that the use of the actual cash working capital over the course of the year is consistent with his calculation of the ADIT and Docket No. 2286 did not require the use of a five quarter average for the cash working capital allowance. As to CIAC, Mr. Effron noted that it is the Commission's practice to deduct non-investor supplied funds from rate base but he agreed to use a five-quarter average balance of CIAC. Lastly, Mr. Effron stated that Mr. Riccitelli had not adequately explained why the $660,242 in environmental costs should be included in the ESM calculation. Thus, Mr. Effron calculated an ESM credit for fiscal year 2004 of $443,000.[15]

VII. HEARING ON NON-ESM

Following published notice, a public hearing was conducted on October 19, 2004, at the Commission's offices at 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

FOR NEGAS:	Robert Keegan, Esq. Cherly Kimball, Esq.
FOR DIVISION:	Paul Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Steven Frias, Esq. Executive Counsel

At the October 19, 2004 hearing, NEGas presented as its witness Mr. Czekanski, who indicated that the revised DAC charge is $0.0019 per therm, which was filed on October 15, 2004. He stated that the DAC will increase rates for the typical residential heating customers by $28 for the year and another $14 increase for the year will be for

[15] Div. Ex. 3 (Effron's surrebuttal testimony), pp. 1-7.

fuel adjusted gas costs.[16] Under cross-examination, Mr. Czekanski stated that the mercury regulator costs for the former Valley Gas were not included in Valley Gas's rates previously and documentation in Docket No. 3401 demonstrates it. Also, Mr. Czekanski acknowledged that NEGas is aware it can seek relief from the Commission or the Division from the Termination Rules in order to make an effort to reduce its undercollectibles and bad debt write-offs for people who are not making a good faith effort to pay their bills.[17]

At an open meeting on October 21, 2004, the Commission adopted the DAC factors filed by NEGas on an interim basis. Also, the Commission required NEGas to file reports assessing the LNG allocation with the next DAC filing as well as semi-annual ERC reports.

VIII. FIRST HEARING ON ESM

On November 19, 2004, the Commission reconvened its hearing in the DAC proceeding. Mr. Riccitelli testified on behalf of NEGas. He stated that NEGas disagreed with the Division on the issues of prepaid PUC assessment, CIAC and the earnings calculation, arguing they were overstated by $573,000 for environmental remediation costs. Under cross-examination, Mr. Riccitelli admitted that the prepaid PUC assessment was not included in the previous lead/lag study for ProvGas. Also, Mr. Riccitelli acknowledged that for fiscal year 2003, NEGas had a negative prepaid PUC assessment expense balance, but explained that this was due to some misclassifications when the companies were merged. However, Mr. Riccitelli agreed with the Division's calculation of ADIT and cash working capital. As for CIAC, Mr. Riccitelli admitted that if NEGas

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[16] Tr. 10/19/04, pp. 6, 9-10.
[17] Id., pp. 16, 53.

has collected those funds from customers it would have use of them. Under further cross-examination, Mr. Riccitelli explained that incentive compensation for NEGas employees increased from approximately $400,000 in fiscal year 2003 to almost $1.5 million in fiscal year 2004 because of approximately $355,000 in carry-over from fiscal year 2003. He explained that at the time the books were closed for fiscal year 2003 it was mistakenly determined that the additional incentive goals had not been met.[18]

Ms. Karen Czaplewaski testified as to various uncollectibles and collection issues. She admitted that a balance of $2,500, or more, which occurred for 383 accounts for fiscal year 2004, is a significant amount of debt for a residential customer to carry and that when the arrearage reaches $1,500 the customer will have a problem paying the past due amount. She indicated that the way the moratorium is structured encourages people not to pay and to game the system. She also indicated that NEGas does not use its LIHEAP matching funds to pay down a customer's outstanding balance without restoring service.[19]

IX. DATA RESPONSES AND OTHER FILINGS

On February 7, 2005, the Division filed a memorandum indicating that the Division agreed to NEGas' correction of $573,422 to the ESM calculation. Mr. Effron agreed that $573,422 was improperly credited to the cost of gas expense for insurance proceeds related to environmental remediation costs. Thus, Mr. Effron agreed that the cost of gas deducted from operating revenues in order to determine operating income for

[18] Id., p. 40-42.
[19] Id., pp. 50-52, 66-67, 78.

fiscal year 2004 should be increased by $573,422 for a total revenue sharing refund for fiscal year 2004 of $156,000.[20]

On February 23, 2005, NEGas filed a response to the Commission's data request indicating that it will not seek recovery for any portion of the incentive compensation related to Southern Union reaching the earnings goals. As a result, NEGas excluded an additional $96,049 from the ESM calculation because NEGas had already excluded 50 percent of the $192,098 of Southern Union's incentive compensation in its initial filing.[21]

X. SECOND ESM HEARING

On February 28, 2005, the Commission conducted another hearing on the ESM portion of the DAC. Mr. Riccitelli acknowledged that for fiscal year 2004 a new safety and customer service incentive was created for management. He also acknowledged that the incentive for fiscal year 2004 was larger than the incentive for fiscal year 2003, even though NEGas earned less in fiscal year 2004 than in fiscal year 2003. Also various record requests were made regarding NEGas' pensions.[22]

After receiving record responses from NEGas on May 25, 2005, the Commission had an open meeting on May 31, 2005. The Commission decided to adopt as the final DAC factors all the factors agreed to by the parties. However, for the ESM, the Commission adopted the Division's position regarding CIAC, accepted NEGas' position regarding the prepayment of the PUC assessment and excluded 75 percent of earnings incentive for fiscal year 2004 as well as the entire safety/customer service bonus for management. Lastly, the ERC reports were directed to be filed for the periods ending

[20] Div. Ex. 6.
[21] NEGas' PUC Data Resp. (2/23/05).
[22] Tr. 2/28/05, p. 15, 19, 30-33.

December 31st and June 30th with the reports due 45 days after the end of the reporting period.

COMMISSION FINDINGS

I. NON-ESM PORTION OF THE DAC

The DAC is composed of various factors: LNG, ERC, DSM, LIAP, Weather Normalization, On-System Margins, Reconciliation, and the ESM. In regards to the LNG factor, LNG commodity costs are projected to increase to a level requiring $0.0056 per therm. The rate increase is therefore justified. However, since LNG is being utilized more to satisfy winter peaking needs, the Commission required NEGas to monitor and file a report with its future DAC filings to determine if the LNG allocation between system pressure and the GCR is appropriate. Also, the Division slightly increased the ERC factor credit. The environmental response costs incurred through June 30, 2004 and incorporated into the factor have not been reviewed for prudence or reasonableness. As a result, the Commission approved the slight increase in the ERC credit factor as being in the public interest but expressly reserved the right to review the prudence and reasonableness of these costs. Thus, to ensure a more timely and thorough review of the ERC, the Commission required NEGas to file semi-annual reports detailing their expenditures as of December 31st and June 30th within forty-five days of the end of each reporting period. In addition, NEGas proposed a Weather Normalization credit of $522,000 to reflect the colder than normal winter of 2003 to 2004. This credit was appropriately calculated. As for the non-firm margin factor, NEGas filed a credit of $0.0007 per therm or $246,514. which appears accurate. Regarding the reconciliation factor, NEGas proposed a factor of $0.0015 per therm due largely to LNG commodity costs being higher than projected for fiscal year 2004. The undercollection needs to be recovered and, therefore, the Commission approves this factor.

The remaining components of the DAC, except the ESM factor, were unchanged. However, the Commission can reduce the DSM factor if the funds are not being utilized. As for the LIAP factor, the Commission states once again that there is already approximately $1.8 million in ratepayer funds being utilized to assist low income families.

II. ESM

Under Title 39 of the Rhode Island General Laws, the General Assembly has delegated its ratemaking power to this Commission to establish just and reasonable rates. In this case, the Commission must interpret the NEGas Merger Rate Settlement approved by Order No. 17381 in Docket No. 3401. The most pertinent phrase of the NEGas Merger Rate Settlement in calculating earning sharing is that the financial results "will be adjusted to reflect established Commission ratemaking principles."[23] A few differences arose during the proceedings as to how to calculate NEGas' earnings for fiscal year 2004. The Commission will now review each of the Division's proposed adjustments as well as other adjustments that the Commission, on its own initiative, deemed necessary to consider.

A. UNCONTESTED ADJUSTMENTS

There were numerous adjustments to NEGas' ESM calculation which were agreed to by the parties. First, the Division increased NEGas' operating income by $162,000 to reflect a gain from the disposition of property. This is appropriate because the property is utility property and thus, the gain from the sale of the property must be included in the

[23] Order No. 17381, Settlement Agreement.

ESM calculation. Second, the Division did not deduct the interest expense on the conservation loan program from operating income. This is reasonable because the conservation loan program represents non-investor supplied funds. Third, the Division made adjustments to ADIT and cash working capital so that a year long average is utilized rather than simple utilization for the figure for the last quarter of the fiscal year. For a business entity like NEGas, the Division's adjustments are reasonable. Fourth, it is quite appropriate to exclude from the ESM the entire $192,098 of incentive compensation expense related to Southern Union's earnings since Southern Union's overall earnings do not benefit ratepayers. Fifth, NEGas made an adjustment to eliminate $573,422 from the ESM calculation because this amount was improperly credited to the cost of gas expense when it represents insurance proceeds related to environmental remediation costs. After a review of the relevant documentation, the Division concurred with this adjustment. Since this appears to be a legitimate accounting correction by NEGas, this adjustment can be approved.

B. PREPAYMENT OF PUC ASSESSMENT

The Division recommended that the prepayment of the PUC assessment should actually represent a negative prepaid item that would reduce the rate base by $133,000. However, this approach would create the unusual situation of a negative prepayment when, under GAAP, prepayments should be either positive or zero. Although the Commission is not required to follow GAAP, it is apparent that the timing of when the invoice is sent to be paid is within the control of the regulators rather than NEGas. Furthermore, there is no clear need to deviate from GAAP in these circumstances. Thus, the Commission will not adopt the Division's prepayment adjustment of $133,000 for the PUC assessment.

C. CONTRIBUTIONS IN AID OF CONSTRUCTION

The Division recommended that CIAC, in the amount of approximately $759,000, be eliminated from rate base. The Merger Rate Settlement approved in Docket No. 3401 states: "Construction work in progress will be included in rate base and the allowance for funds used during construction will be included in operating income."[24] However, there is no mention of CIAC in the Merger Rate Settlement. Thus, the Commission can follow general ratemaking principles. NEGas acknowledged that CIAC funds do come from ratepayers. It is a ratemaking principle to exclude non-investor supplied funds from rate base. In fact, the Commission has done so in electric utility cases. If, in the past, CIAC has not been an issue, it is because CIAC did not appear as a discrete item on NEGas' balance sheet. Accordingly, the Commission will follow this ratemaking principle and exclude CIAC from the rate base.

D. INCENTIVE COMPENSATION

In the previous NEGas ESM calculation, the Commission allowed, as an expense, approximately $173,510 in earnings incentive and approximately $25,000 in a bonus related to safety and customer service for non-management employees. Furthermore, the total earnings for ratepayers were approximately $5,311,000 in the previous ESM calculation. However, the Commission stated that it would "remain vigilant to insure that an incentive does not become too large, too easy to achieve or become based on factors that are a detriment to ratepayers."[25]

[24] Order No. 17381, Settlement Agreement.
[25] Order No. 17971.

In this proceeding, NEGas is seeking approximately $413,094.50 in incentive compensation for fiscal year 2004, an additional $177,500 for fiscal year 2003, as well as $104,726 related to a bonus for a customer service and safety for both management and non-management personnel.[26] However, the total earnings sharing credit for fiscal year 2004 was less than $500,000. Since the ratepayer share of the incentive for fiscal year 2004 would be approximately $413,094, this is simply "too large" an incentive for ratepayers to pay in light of the amount of earnings credit they receive. Because NEGas barely earned an ROE above 11.25 percent, instead of above 12.25 percent for fiscal year 2003, the benefit of fiscal year 2004 earnings overwhelmingly went to NEGas and only a small benefit is for ratepayers. Accordingly, the Commission will allow only 25% of the incentive, instead of 50%, because the incentive was too large for an earnings credit so small. Thus, the ratepayers will pay only $206,547 instead of $413,094 in the ESM calculation.

As for fiscal year 2003, NEGas accrued an additional $355,000 incentive of which NEGas is seeking $177,500 to be included in the ESM calculation. NEGas explained that it had not been included originally because Southern Union had questioned whether NEGas' management had met its earnings goal in light of the Commission's decision to refund $5.2 million in 2003. Their explanation is reasonable. Furthermore, this additional $177,500 only raises the overall incentive for fiscal year 2003 to approximately $351,000 when ratepayers received a credit of $5.3 million. This is a reasonable ratio of the amount of an incentive to the earnings credit.

In regards to the bonus for customer service and safety, the Commission will allow the expense for the portion of the bonus for non-management employees as it did in

[26] NEGas PUC Record Response 6-1 (2/23/05).

the last ESM calculation. However, NEGas has not demonstrated the necessity or benefit for creating a customer service and safety bonus for management employees.[27] As a matter of fact, the bonus program for management personnel is essentially identical to the bonus program already existing for non-management personnel, and is thus duplicative. Furthermore, this additional bonus program has not benefited ratepayers. For instance, the abandoned call rate for fiscal year 2003 was 5.81 but it worsened to 6.73 for fiscal year 2004.[28] Accordingly, the Commission will exclude $59,926 of the expense for the safety and customer service bonus for management from the ESM calculation.

E. OTHER ISSUES

Other issues were examined in this proceeding. First, NEGas incurred $12,200 in legal expenses for unsuccessfully appealing a Commission order in Docket No. 3401 requiring the disclosure of NEGas' lock-out expense. The Commission can disallow excessive or unnecessary legal expenses.[29] It is unclear how keeping this information confidential benefited ratepayers. However, this is a very small amount of legal fees and therefore, can not definitively be deemed as excessive. Furthermore, the issues addressed on appeal were of a novel nature and thus, can not be deemed frivolous. As a result, the Commission will not disallow this expense. Second, NEGas' bad debt write-offs for fiscal year 2004 had increased to $11,530,015 from $4,549,413 for fiscal year 2003. This is a significant increase. The Commission is well aware of the legal restraints placed upon NEGas in its collection practices. However, NEGas had 383 accounts in fiscal year 2004 with bad debt write-offs of $2,500 or more, which is clearly a problem. Even NEGas admitted that when a customer's arrearage reaches approximately $1,500 the

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[27] NEGas Rec. Resp. 2 (4/6/05).
[28] Compare SQP reports dated 12/22/03 and 7/3/04.
[29] Order No. 13877.

customer will have a problem paying the past due amount. NEGas must exercise more due diligence in its collection efforts to ensure that accounts do not reach high levels and result in high bad debt write-offs. Third, NEGas' pension expense for fiscal year 2004 increased. NEGas explained that fifty percent of the increase in pension expense was due to a decline in market value of plan assets and that fifty percent was due to a decrease in the discount rate resulting from falling bond rates.[30] While there does not appear to be any inappropriate manipulation by NEGas to exaggerate its pension expense, NEGas also does not appear to be taking advantage of the current tax code to pay the maximum tax deductible contribution to its pension fund.[31] NEGas must be made aware that it is in the long-term interest of ratepayers to have a properly funded pension fund.

To summarize, the Commission will adopt the positions agreed to by parties in the DAC, except for the ESM calculation in which the Commission will: utilize NEGas' approach regarding prepayment of the PUC assessment, exclude CIAC from rate base, exclude 75% instead of 50% of the earnings incentive expense for fiscal year 2004, and exclude management's safety/customer service bonus expense for fiscal year 2004. As a result, NEGas' earnings credit will be approximately $284,000 for fiscal year 2004 and an additional $99,000 for fiscal year 2003.

Accordingly, it is

(18365) ORDERED:

1. The system pressure factor of $0.0056 per therm filed on September 3, 2004 by New England Gas Company is approved for effect November 1, 2004.

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[30] NEGas PUC Rec. Resp. 6 (5/12/05).
[31] NEGas PUC Data Resp. 3-9 (5/25/05).

2. The environmental response cost factor of ($0.002) per therm filed on October 15, 2004 by New England Gas Company is approved for effect November 1, 2004.
3. The weather normalization factor of ($0.0015) per therm filed on July 30, 2004 by New England Gas Company is approved for effect November 1, 2004.
4. The reconciliation factor of $0.0015 per therm filed on July 30, 2004 by New England Gas Company is approved for effect November 1, 2004.
5. The on-system margin credit factor of ($0.0007) per therm filed on July 30, 2004, by New England Gas Company is approved for effect November 1, 2004.
6. The Earnings Sharing Mechanism factor ($0.0011) cents per therm proposed on September 3, 2004 by NEGas is approved on an interim basis for effect November 1, 2004.
7. The Earnings Sharing Mechanism factor will be adjusted to reflect the adjustments made by the Commission within this Report and Order for effect November 1, 2005.
8. New England Gas Company shall comply with all other findings and instructions contained in this Report and Order.

EFFECTIVE NOVEMBER 1, 2004 AT WARWICK, RHODE ISLAND PURSUANT TO OPEN MEETINGS ON OCTOBER 21, 2004 AND MAY 31, 2005. WRITTEN ORDER ISSUED SEPTEMBER 13, 2005.

PUBLIC UTILITIES COMMISSION

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Elia Germani, Chairman

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Robert B. Holbrook, Commissioner